HELP ?

The global financial crisis and economic reform in the Middle East

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Abstract:
Richards discusses the likely impact of the current international financial crisis on the trajectory of reform of governments in the Middle East and North Africa.

Full Text:

"The caravan passes while the dogs bark" - Egyptian proverb hat is the likely impact of the current international financial crisis on the trajectory of reform of

governments in the Middle East and North Africa? A process of economic reform has been underway for nearly a decade throughout the region. The "Washington Consensus" package of reforms, leading to greater reliance on the private sector, has been widely viewed in U.S. policy and academic circles as the key to successfully stimulating the very large volume of capital investment that is needed to cope with the region's serious socioeconomic problems. However, the Washington Consensus view has been that reforms were moving sluggishly and that, in particular, the absence of open capital markets helped to keep the region mired in economic stagnation.

By contrast, regional leaders and analysts often countered that political stability necessitated gradualism, and that opening capital markets was a tricky business because of the potentially large down-side risks involved. Government actors were loath to make any precipitous changes, not only out of fear of provoking social disorder, but also from disquiet over losing potential levers of power, such as state-owned enterprises. They argued that they understood the need to change but that the changes should be done slowly. The crash of 1997 in Asia and the subsequent seizing up of emerging-market lending are likely to confirm Middle Eastern governments' view that they are wise to move gradually.

KEY ECONOMIC PROBLEMS AND THE DEMAND FOR CAPITAL1

The core problems facing the political economies of the region have not been unchanged by the recent global financial crisis. (As we shall see later, coping with these problems has been made even more difficult than before.) These problems may be summarized as follows:

Restoring economic growth

Restraining population expansion

Providing jobs

Coping with urbanization

Saving water

Obtaining food

Halting environmental destruction

For our purposes, the key issue is that dealing with each of these will require capital investment on a very large scale.

The severity of the problems seems clear enough. From 1985 to 1995 output per person declined at about 0.3 percent per year.2 Given data deficiencies, one can simply say that the region has stagnated during the past decade. Real wages and labor productivity are about the same as in 1970.

Meanwhile, the population of the Middle East and North Africa is now growing at about 2.7 percent per year, which means that the population will double in slightly more than a quarter century (26 years). This is the second fastest rate in the world: only sub-Saharan Africa has a higher rate of population growth. Population growth rates have fallen quite sharply in the past 10 years (from 3.2 percent in the mid-1980s to 2.7 percent in 1992). Sharp fertility

declines caused this change; there are reasons to expect further falls. However, populations will keep growing, both because fertility remains well above replacement levels and because past population growth ensures that there are many women who will soon enter their child-bearing years. The population of the region may reach roughly 600 million by 20253, some six times more people than in the 1950s. By 2025, the number of people aged 0-14 will roughly double.

Most directly significant from a political-economy perspective, the rate of growth of the labor force has accelerated slightly (from 3.2 percent in the 1980s to 3.3 percent, 1990-95). An immediate consequence of the combination of economic stagnation and rapid labor-force growth is a complex mix of rising poverty and rising unemployment. Both indicators are notoriously difficult to measure accurately. Nevertheless, some ball-park estimates would be that unemployment rates are around 15 percent on average, and poverty levels are rising.' Most of the jobless are young, semi-educated, urban people, whose anger fuels political unrest. The countries with the worst problems are Algeria, Egypt, Jordan, Saudi Arabia, Syria and Yemen.

In addition to the core problems of growth, poverty reduction and job creation, countries of the region face additional challenges posed by rapid urbanization. The number of urban dwellers is growing more rapidly than populations as a whole: the number of urban Middle Easterners has increased by about 100 million in the past 35 years. Roughly half of the population of the region now lives in cities. The numbers of urban dwellers is expected to rise from its current level of over 135 million (excluding Turkey) to over 350 million by 2025. From 1985 to 1990, the most rapid growth was in secondary cities - 6 percent - compared with a growth rate of 3.8 percent for the 19 largest cities with populations over 1 million in 1990. Public services and utilities are already overwhelmed; in Jordan and Morocco, for example, onethird of the urban population lacks adequate sewerage services. Urban water supplies are often erratic. Governments attempt to provide urban services through heavy subsidies, which strain government budgets. It is difficult to find the funds necessary to make the investments needed to extend and improve services.

Water scarcity is another critical problem. Renewable water resources per capita fell from 3,500 cubic meters (m^sup 3)^ in 1960 to 1,500 m3 in 1990. The World Bank projects that there will be only 667 m3 per person by 2025 (compared with a worldwide average of 4,780 m3 per person in that year). Ten countries' (plus Gaza's) water use already exceeds 100 percent of renewable supplies. Deterioration in water quality exacerbates water quantity problems. The burden of adjustment to water scarcity must fall on the agricultural sector, because the economic value of water is much lower in farming than for domestic or industrial use. However, the opposition of powerful interest groups blocks such reallocations. Government water management systems suffer from lack of funds and from organizational cultures which were geared to a situation of relatively abundant water. Finally, most regional rivers and aquifers cross international frontiers. Political fears inhibit economic/engineering solutions, which would favor managing a river basin as a unit. As the most recent tensions between Syria and Turkey dramatically remind us, water issues can greatly exacerbate already tense interstate relations in the region.

A corollary of the water problem is the need for large food imports. The Middle East is the least food-self-sufficient region in the world. During the 1980s, demand growth decelerated (thanks to declining incomes) and supply response accelerated; in the 1990s, the growth rate of the agricultural sector decelerated (from 4.5 percent in the 1980s to 3.3 percent, 199095). The region's agricultural sectors have used more land, more water, more fertilizer, more machines and more labor all just to keep up with population growth. The water constraint dooms attempts at food self-sufficiency, which in any case is an economically foolish approach to the problem of food security. The region must export in order to eat. Autarchy is not an option.

Finally, the region faces mounting environmental problems. The costs of environmental neglect may be about $14 billion per year - nearly 3 percent of GDP. Deforestation and soil erosion are particularly serious in parts of Algeria, Morocco, Tunisia and Yemen. Air pollution adversely affects the health of 60 million urbanites, some 40 percent of urban populations (20 percent of total populations).

For our purposes, the key point is that managing these problems will require very large sums of money. For example:

To create enough jobs to keep up with the growing labor force for the next 15 years will cost approximately this:

To meet the increasing demand for education in the region as a whole for the next 15 years will require perhaps $26 billion per year. Spending on education will have to rise 200 percent overall, 225 percent in Egypt and 300 percent in Morocco.

Algeria:	$25 billion
Egypt:	$14 billion
Iran:	$31 billion
Morocco:	$30 billion
Tunisia:	$12 billion

Enlarge 200%
Enlarge 400%

To maintain and improve its physical infrastructure, Egypt needs to spend about $2 billion per year; Jordan $500 million per year.

To clean up the environment will cost some $58-78 billion over the next decade. In short, regional political leaders face serious, mounting socioeconomic problems. Managing these problems successfully will require very large sums of money. Due to the decline in oil prices, no government in the region finds it easy to come up with such resources. What remedies did economists recommend?

"THE WASHINGTON CONSENSUS": BARKING DOGS?

Many economists (myself included) advocated some variant of what has come to be known as the "Washington Consensus" to deal with this problem. The remedy was usually a "package" of fiscal rectitude (i.e., cutting government budgetary deficits), exchange-rate realignment, domestic price decontrol, privatization and opening the country up to foreign investment. The hope was that such measures would improve the efficiency of resource allocation, attract investment in the form of nationals' portfolios formerly held offshore, and/or foreign direct and portfolio investment. Numerous conferences and publications5 extolled the virtues of this strategy, and the international agencies (IMF and World Bank) and the U.S. government actively and persistently promoted such policy changes throughout the region (as, of course, elsewhere in the world).

The response in the region has been mixed.6 There has been wide country variance, ranging from minimal changes (as in Syria) to an embrace of stabilization and structural-adjustment programs in Algeria, Egypt, Jordan, Morocco and Tunisia. The trend toward reduced subsidies and privatization has also been notable in the Gulf: Saudi Arabia doubled gasoline prices and sought to privatize. Despite the wide variance in the extent of reforms among different countries of the region, there is no doubt that most countries have adopted at least some of the reforms advocated by the "Washington Consensus."

Until the onset of the current international financial crisis in the summer of 1997, however, there was also a kind of consensus among Western economists who followed economic developments in the region that the reforms were moving too slowly. This "lack of speed" was decried, both because of the mounting problems sketched in the previous section, and because the region's performance seemed so dismal in comparison with that of Latin America and, especially, East and Southeast Asia. Although Middle Eastern and North African governments were viewed as moving in the direction of reforms, it was widely held that they were moving too slowly, and that the pace, particularly of privatization and improving the climate for foreign investment, was depriving the region of the capital which it needed to cope with its mounting problems and to compete with the rapidly growing regions of Asia.

The key argument of the "Washington Consensus" was that a rapid increase in investment and capital inflows was required to provide the jobs necessary for stability. Rapid privatization was often viewed as the key, but other reforms of the capital market were widely advocated. For example, the IMF argued that "progress in financial sector reform now is more urgent than ever if the region is to reap the full benefit of reforms undertaken in other areas, raise significantly the levels on domestic saving and investment, and promote higher economic growth and employment creation."' The report went on to say that greater foreign participation in the financial sector can enhance competition, encourage acquisition of technology and know-how, and help facilitate the integration of Middle Eastern and North African countries in world financial markets. Restrictions on foreign participation in financial intermediaries and in portfolio investment through the stock exchange have been reduced significantly in recent years.... However, further progress is clearly needed.... Greater opening up should be accompanied by the establishment of an adequate regulatory framework for both domestic and foreign investors.8

The World Bank's Claiming the Future summed up the view of the "Washington Consensus" on the region: "MENA's policies are ill-suited to the global economy. "9

A very common indicator of the relatively sluggish pace of reform was the region's very low percentage of the total flow of foreign direct investment (FDI) or foreign portfolio investment (FPI). The Economic Research Forum, a World Bank-funded, Cairo-based regional economic research organization has found that the countries of the Middle East and North Africa did indeed garner a very small amount of international private capital flows in the 1990s.10

The capital-market problems that allegedly produced this outcome included those enumerated above by the IMF but more broadly may be expressed as excessive "statism." Banks were heavily state-owned; regulations were opaque and allowed considerable discretion to government officials; foreign participation was, when allowed, hedged in by numerous restrictions. As Kemal Dervis puts it, "...overregulation, inadequate legal standards, cumbersome bureaucratic procedures and historic hostility to freemarket, private-sector-oriented development make the region a relatively unattractive location for investment."11 Outside of the Gulf, no country of the region embraced the "open capital markets" doctrine of the early 1990s.

THE PASSING CARAVAN: THE LOGIC OF GRADUALISM

Middle Eastern governments had a (typically quiet) rejoinder. They argued that while they were committed to making changes in the direction of a greater role for the private sector, they were not about to move so quickly that key sectors of the population would be put at risk or to abandon all levers of control over the economy. In the case with which I am the most familiar, Egypt, government officials (and their Egyptian academic friends) would politely but firmly say that they, not Americans, knew best how to make a complicated transition toward a more market-friendly political economy while simultaneously protecting political stability. They pointed out that they were "walking in a mine-field," where caution, careful deliberation, preparation of domestic losers and winners for the changes, and safeguards against economic shocks were vital to the regime's security. They argued that, while implementation of reform was indeed often sluggish, there was genuine movement. Most important, from their perspective, there now exists regular consultation between privatesector actors and key government personnel. Such arrangements, they argued, promised to ensure that the interests of private businessmen receive proper attention from policy makers and broadened the social basis of support of governments. "Pragmatism" was the key word of these analysts.

Others argued that although it was perhaps true that the sluggish pace of reform implied slow growth, rapid growth was itself not necessarily desirable from the political perspective of national leaderships. Rapid growth tends to be unbalanced; the key regional example in policy makers' minds was the experience of Iran in the 1970s, with its concomitant revolutionary political implications. "Gradualists" also argued that there was no guarantee that East and Southeast Asian experience was an adequate "model" for the Middle East, because: (1) in the East Asian case (e.g., Korea and Taiwan), international economic conditions in the period of "take-off" (1960s and early 1970s) were fundamentally different from those facing Middle Eastern governments in the 1980s and 1990s; (2) the level of education of the Asian labor force was higher; and (3) regional political stability in Southeast Asia was far higher than in the Middle East. All observers agree that continued threats of regional war provide an independent additional disincentive to foreign investment and to the return of some off-shore domestic capital.

Some economists both in the region and elsewhere noted that there was a strong case to be made that reforms needed to be carefully sequenced. The most prominent American advocate of this view is probably Ronald McKinnon of Stanford University, who argues that fiscal control (i.e., reform of taxes and spending) should precede financial liberalization, that the liberalization of domestic trade and finance should precede liberalization of foreign exchange, and that transactions on the current account should be liberalized well before capital-account transactions.'2 The dangers of excessively rapid liberalization, in which the capital account was liberalized while the government simultaneously maintained an inconsistent policy mix (e.g., an overvalued exchange rate with a government commitment to defend it) was widely agreed to be potentially very dangerous. As the late Carlos Diaz--Alejandro put it (with respect to Chile in the early 1980s), such a policy mix might well mean "goodbye financial repression, hello financial crash."13 Such economic analyses fit well with the actual implementation approaches of reform in places like Egypt and Morocco.

Finally, some of the best-informed local observers pointed out that part of the explanation for the slow pace of reform was generational: while younger policy people might agree with the argument that more rapid reform was needed, they found it difficult to persuade the top leadership, whose politically formative years occurred in a different era. There was, as a young MIT-trained Moroccan technocrat working in the palace put it, "a struggle between us and Jurassic Park," meaning the "old fossils" who placed maintaining control above all other considerations. Such tension implied that reform would continue, slowly, but (optimistically) perhaps steadily toward greater reliance on market forces.

IMPACT OF THE CRASH OF '97: TORTOISE BEATS HARE?

Middle Eastern policy makers, along with the rest of us, now find themselves in an entirely different atmosphere from that of the early 1990s. As the economic difficulties spread from Bangkok to Seoul to Jakarta and then to Moscow (and on to Brasilia?), a worldwide "liquidity crunch" is developing in which investors display that famous "herd behavior," individually rational ("don't be the last one to the exit") but profoundly destructive socially. As the meetings in Washington in early October of this year amply demonstrated, perhaps the only area of agreement is that the world economy is facing deflation and falling output for the first time in decades. Apart from the shared gloom, however, there is little consensus on what should be done to remedy the situation.

Although debates rage (and will likely continue) over the precise origins of the crash in Asia, a few areas of consensus have emerged:

Under pressure from the United States and the international agencies, countries such as Thailand and Korea permitted, for the first time, local banks to borrow dollars;

Very large inflows of foreign capital (often some 10 percent of GDP) flowed into these countries;

In the boom conditions characterizing these economies of the time, asset-price bubbles, particularly in real estate, developed, in which local banks and companies made risky and dubious investments;

Some of the poorly conceived investments were politically motivated and are summed up in the rubric "crony capitalism";

Governments had modestly overvalued currencies (especially true for Thailand), which they promised to defend;

The "moral hazard" problems played some (widely debated) role, as domestic investors believed that they would be bailed out, while multinational investors believed that the IMF and the U.S. Treasury would help.

Once the crisis began in earnest, the IMF's remedy of raising interest rates to defend the currency provoked still more bankruptcies. 14

Once Russia defaulted, already frightened investors have become markedly more risk-averse and are now highly reluctant to invest anywhere except the strongest economies, such as the United States and the EU.

The domestic consequences for Asian countries have been very severe, with output declines of up to 25 percent, unemployment rates doubling, and very marked increases in poverty, most dramatically in Indonesia.

What lessons do Middle Eastern policy makers draw from all of this? Of course, in the more immediate term, they have to contend with the adverse impact of falling oil prices and sluggish demand for their other exports. Fortunately, so far the crisis has not spread to Europe, where any slackening of import demand, combined with the fall in oil prices, would put great strain on many Middle Eastern and North African current-account balances. If the crisis continues to deepen, governments of the region will face additional deflationary pressure. Consequently, their first priority will be macroeconomic crisis management.

This might or might not slow reform. Indeed, some argue that the need for macroeconomic stabilization provides a good "cover" for other reforms, such as trade reforms.15 However, most countries of the region have already substantially reformed their commodity-trade regimes. My own sense is that most regimes do indeed wish to continue to privatize (witness, for example, the tender of Moroccan telecoms last September), but that finding appropriate buyers may well become more difficult. But I would predict that Morocco and Egypt will continue to seek to privatize.

The clearest lesson to be drawn is that there are dangers: (1) governments may lose control over the financial sector, and (2) large-scale speculative capital may flow in. The countries of the Middle East have been largely spared the problems facing Asia and Latin America, because, like China, they have not liberalized their capital accounts to nearly the same extent.lb Middle Eastern leaders are likely to draw the same conclusions as Senior Minister Lee Kuan Yew of Singapore:

Asian countries would have been better off if they had never opened up the economies to the extent they did....Remember in Thailand up 'til 1990 the capital account was closed. Had it remained closed, their borrowings would have been in baht, and they would not have collapsed in this precipitous way. As for Indonesia...,they had strict foreign-- exchange controls that enabled them to check the excessive inflow and outflow of short-term capital. American and European bankers pressed for a financial-sector agreement under WTO. We were all told how our economies would blossom....

The senior minister goes on to argue that, despite this, there is now no alternative but for the countries of the region to deepen their process of liberalization. Here the senior minister agrees with the U.S. Treasury and the IMF. Of course, other regional leaders, most notably Prime Minister Mahathir of Malaysia, take a different view and have reimposed capital controls. Such latter views are likely to command considerable sympathy among Middle Eastern governments.

The IMF, of course, remains unrepentant and undaunted. A recent publication notes that, despite the much more restrictive capital-account systems of most countries, some Middle Eastern states have some of the same potential difficulties of Asian countries: overly rigid exchange-rate pegs, weak prudential regulation and financial-system supervision, insufficient transparency and so forth.18 He argues that there is a "growing consensus among regional policy makers that these issues need to be addressed," and that "a properly sequenced opening of countries' capital accounts needs to be pursued."

Perhaps, but one is entitled to skepticism. In particular, it seems highly unlikely that a deepening international financial crisis and worldwide deflation will provide an environment favorable to further reforms of the sort advocated by the Washington Consensus. More likely, perhaps, is that the cautious, pragmatic approach of gradual reform, of "testing the waters," will continue. The call for "greater transparency" may make economic sense, but it is equally clear that devising systems for the rule of law and for adequate prudential regulation of the financial system take decades, not months. After all, even today in the United States, with several centuries of experience with the problem, we still face the need for emergency transfusions from taxpayers to insolvent financial houses (most recently, of course, the bail-out of Long Term Capital Management). It seems unlikely, and arguably unwise, for Middle Eastern and North African countries to embrace rapid capital-market liberalization today.

None of this means that countries of the region are likely to try to return to the old model of state socialism. Nor does it mean that they will try to withdraw from the international economy; they know perfectly well that they cannot do this. Neither does it mean that the pressing problems outlined in the first section will go away, nor that the capital needed to manage them successfully will more easily be acquired. Indeed, obtaining such capital will be even more difficult than in the past, since investors are likely to demand very high-risk premiums. A region facing sluggish growth, rising poverty and unemployment, and a vast need for capital is in no position to cheer. But they may heave a sigh of relief that they have averted the worst-case scenario.

After all, for the key players, the bottom line is now and always has been the same: political stability. Middle Eastern regimes could not withstand the social and political consequences of the kind of economic collapse experienced in Southeast Asia, and they know it. Their final conclusion is likely to be that they were right to ignore often-arrogant advice and to "make haste slowly." They are likely to conclude that "the caravan passes, while the dogs bark." Keeping the caravan going, as regional peace, oil prices and (perhaps) the international economy crumble, will, however, be no easy task.

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' This section reviews and updates the argument of my argument in "Economic Origins of Instability in the Middle East," Middle East Policy, Vol. IV, No. 1-2, September 1995, pp. 175-187. 2 The World Bank, Claiming the Future: Choosing Prosperity in the Middle East and North Africa (Washington, DC: The World Bank, 1995). 3 The World Bank, 1994.

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4 Ragui Assad, Alan Richards, Charles Schmitz, and Michael Watts, Human Security for the New Millenium: Poverty and Sustainable Livelihoods in the Arab Region: Elements for a Poverty Alleviation Strategy (New York: UNDP, 1996).

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5 Some of the most visible publications include World Bank (1995) and IMF (1996). 6 Alan Richards and John Waterbury, A Political Economy of the Middle East. Second Edition, 1996 (Boulder and London: Westview Press, 1995). ' Building on Progress: Reform and Growth in the Middle East and North Africa (Washington: IMF, Middle Eastern Department, 1997), p. 35. 8 Ibid., p. 49.

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9 The World Bank, p. 15. '10 It is notable, however, that Morocco has succeeded in attracting considerable French and Spanish investment, by some estimates amounting to up to 20 percent of total investment flows.

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" Kemal Dervis, et al., "Intraregional Trade Among Arab Countries: Building a New Economic Neighborhood" (Middle East Institute Conference, Washington, DC, October IS-17, 1998). 12 The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy (Baltimore: Johns Hopkins University Press, Second Edition, 1991). 13 "Goodbye Financial Repression, Hello Financial Crash," Journal of Development Economics. 19, September/October, 1-24, 1985.

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14 Whether, of course, a falling currency would have bankrupted still more companies with large dollar-- denominated debts is an empirical question. It is notable that there is very little empirical information on the relative size of these two forces for bankruptcy. 15 Dani Rodrik, "Political Economy of Reform" in Stephan Haggard and Steven B. Webb, eds, Voting for Reform: Democracy, Political Liberalization and Economic Adjustment (Washington, DC: World Bank, 1994), pp. 43-87.

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16 Middle Eastern firms also typically are much less highly leveraged than Asian firms. Middle Eastern firms tend to depend largely on retained earnings or other non-bank sources of capital. 1 Far Eastern Economic Review, September 24, 1998, p. 11. '18 Paul Chabrier, "How Has the Asian Crisis Affected Other Regions? The Middle East and North Africa," Finance and Development, September 1998, pp. 16-17.

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